DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0516
Gross Income Tax
Tax Year 1997

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ISSUES

I. Gross Income Tax – Agency

Authority: IC 6-2.1-2-2;
45 IAC 1-1-54;
Policy Management Systems Corp. v Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999);
Universal Group Ltd. v. Indiana Dep't of State Revenue, 609 N.E.2d 48 (Ind. Tax 1993);
Western Adjustment and Inspection Co. v. Gross Income Tax Division, 142 N.E.2d 630 (Ind. 1957);
Monarch Steel Co. v. State Bd. Of Tax Comm'r, 699 N.E.2d 809, 811 (Ind. Tax Ct. 1998);
Trinity Episcopal Church v. State Bd. Of Tax Comm'r, 694 N.E.2d 816, 818 (Ind. Tax. Ct. 1998);
Department of Treasury v. Ice Service, Inc., 41 N.E.2d 201,203 (1942);
Johnson v. Blankenship, 679 N.E.2d 505, 507 (Ind. Ct. App. 1997).

Taxpayer protests the imposition of state gross income tax on amounts allegedly received in an agency capacity.

II. Gross Income Tax – Health Maintenance Organizations and "Gross Premiums"

Authority: 45 IAC 1-1-68

Taxpayer protests the imposition of state gross income tax on amounts characterized as "gross premiums."

III. Tax Administration: Negligence Penalty

Authority: IC 6-8-10-2.1;
45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

M HMO provides a variety of prepaid healthcare plans. Covered services may be paid directly by plan enrollees, paid indirectly by private insurance companies or, paid by Medicaid. In providing coverage of Medicaid paid services, M HMO contracted with the State of Indiana "to administer a risk-based managed care program for certain Medicaid recipients." M HMO, though, did not directly provide medical services to its program enrollees. Rather, M HMO contracted with a number of hospitals and other healthcare providers to provide for these covered services. Taxpayer was one such provider.

With regard to the Medicaid managed care program, M HMO and Taxpayer (a "participating provider") reached an agreement ("the AGREEMENT") to "facilitate the provision of cost effective, covered health care services" to M HMO enrollees. (The AGREEMENT characterized the legal relationship between M HMO and Taxpayer as one for the provision of "personal services.") Specifically, M HMO, as the administrator of prepaid healthcare plans, contracted with Taxpayer and its Participating Providers to provide "Covered Services" to M HMO program enrollees. In exchange for Taxpayer's provision (or arrangement) of "Covered Services," M HMO agreed to pay Taxpayer certain fees in accordance with a predetermined fee schedule.

With regard to the adopted "reimbursement" scheme, [TAXPAYER] received from [M HMO] a **monthly** fixed amount for each program ENROLLEE. This fixed amount was a function of the designated AFDC AID CATEGORY. From these payments, seven dollars ($7.00) per ENROLLEE per month was allocated to TAXPAYER for administrative services.

Taxpayer provided [M HMO] with a **quarterly** reconciliation statement. The reconciliation statement was used to compare (1) the amount of payments made by TAXPAYER to providers of covered medical services under the AGREEMENT with (2) the reimbursement amounts paid to TAXPAYER by [M HMO]. "If [TAXPAYER] payments for [covered services] exceed[ed]…payments [made] to [TAXPAYER], then [M HMO] shall fund to [TAXPAYER] the amount of the difference."

The AGREEMENT also required an **annual** reconciliation. The annual reconciliation served, functionally, to apportion certain types of accumulated surplus or deficit.

> Medical Pool Costs shall be compared to the Medical Pool Budget. If Medical Pool Costs are less than the Medical Pool Budget, [M HMO] and [TAXPAYER] shall share equally in the loss up to the point at which [TAXPAYER'S] share of the loss is equal to seven dollars ($7.00) per ENROLLEE per month allocated to [TAXPAYER] for administrative services. Thereafter, [M HMO] shall bear 100% of any loss.

The AGREEMENT also contained a STOP LOSS PROVISION. "[M HMO] and [TAXPAYER] shall share the cost of certain high cost cases."

Audit and Taxpayer disagree as to the characterization—for Indiana gross income tax purposes—of the "reimbursements" Taxpayer received from M HMO. Audit characterized the reimbursements as gross receipts derived from "the provision of services." These receipts, according to Audit, should have been included in Taxpayer's high-rated taxable gross receipts (see IC 6-2.1-1-2, IC 6-2.1-2-3, and IC 6-2.1-2-5(9).) Taxpayer, on the other hand, insists the reimbursements could not have represented taxable gross income because taxpayer lacked a beneficial interest in them. Taxpayer explains:

> It is [Taxpayer's] position that because it was merely acting on behalf of, and at the direction of M HMO with respect to those Medicaid funds and because it had no right, title, or interest in those Medicaid funds, it had no gross income tax liability on those funds.

The disagreement as to the proper characterization of the "reimbursements" resulted in assessments of Indiana gross income tax. Taxpayer protested the additional assessments. An administrative hearing was held. The results of which now follow.

I. Gross Income Tax – Agency

DISCUSSION

Indiana imposes a gross income tax upon the entire gross receipts of taxpayers who are residents of, or domiciled, in Indiana. IC 6-2.1-2-2(a)(1). For those taxpayers who are not residents of, or domiciled in, Indiana, the tax is imposed only on the gross receipts derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However, pursuant to regulation and case law, gross receipts received in an agency capacity are not included in taxpayer's taxable gross income. Regulation 45 IAC 1-1-54 states that "[t]axpayers are not subject to gross income tax on income they receive in an agency capacity." 45 IAC 1-1-54(a).

Indiana case law reinforces the regulatory regime. "Reimbursements to an agent for amounts advanced or paid to third parties substantively represent 'pass throughs' of income and therefore

are not taxable to the agent." Policy Management Systems Corp. v Indiana Department of State Revenue, 720 N.E.2d 20, 23 (Ind. Tax Ct. 1999) quoting Universal Group Ltd. v. Indiana Dep't of State Revenue, 609 N.E.2d 48, 54 (Ind.Tax 1993) (UGL I).

Before taxpayer may exclude income from its taxable gross receipts, taxpayer must show that its reimbursements were not subject to the state's gross income tax. That is, taxpayer bears the burden of proof. *See* Western Adjustment and Inspection Co. v. Gross Income Tax Division, 142 N.E.2d 630, 635 (Ind. 1957). This allocation of the burden of proof is consistent with that of other tax exemptions. Indiana courts consistently have held that tax exemptions are to be strictly construed against the taxpayer and in favor of taxation. Monarch Steel Co. v. State Bd. Of Tax Comm'r, 699 N.E.2d 809, 811 (Ind. Tax Ct. 1998). Trinity Episcopal Church v. State Bd. Of Tax Comm'r, 694 N.E.2d 816, 818 (Ind. Tax. Ct. 1998).

The Indiana Supreme Court has adopted the definition of agency which is found in Section 1 of the *Restatement of Agency*. The *Restatement* defines "agency" as "the relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Universal Group Ltd. v. Indiana Dep't of State Revenue, 642 N.E.2d 553, 556 (Ind.Tax 1994) (UGL III) citing Department of Treasury v. Ice Service, Inc., 41 N.E.2d 201,203 (1942). "Thus, a party claiming the existence of an agency relationship must prove three elements: (1) a manifestation of consent by the principal to the agent, (2) an acceptance of the authority by the agent, and (3) control exerted by the principal over the agent." Policy Management Systems, 720 N.E.2d 20, 23-24, citing Johnson v. Blankenship, 679 N.E.2d 505, 507 (Ind. Ct. App. 1997).

Taxpayer's arguments are silent with regard to the legal requirements characteristic of agency relationships—i.e., (1) consent, (2) authority, and (3) control. Rather than offering a legal narrative, taxpayer has based its plea on equitable notions. Taxpayer reasons:

> This case…should not be about what might have happened, but what actually did happen. … All of the amounts from M HMO…were actually passed through by [Taxpayer] to pay medical and health care claims for Medicaid recipients as was required under [Taxpayer's] agreement with M HMO. … After the medical and health care claims were paid, there were no excess amounts left over for [Taxpayer] and M HMO to share or even to pay [Taxpayer] an administrative fee.

The economic effects of the contract, however, do not, even in hindsight, determine the relationship of the parties to the contract. Rather, it is the language of the contract coupled with the parties' actual performance under the contract that determine the parties' legal relationship. Nothing in the contract, or the way in which the parties performed the contract, suggests an agency relationship existed.

Taxpayer's own statement belies its contention that an agency relationship existed.

> [U]nder no scenario could [Taxpayer] ever keep more than 50% of the surplus. The fact that the auditor would impose tax against [Taxpayer] on 100% of the funds when the absolute most [Taxpayer] could ever keep was 50% of the surplus that remained after all claims were paid illustrates the unreasonableness of the auditor's position.

Taxpayer is mistaken. The auditor's position simply reflects the nature of Indiana's gross income tax. The subject of the tax imposed by IC 6-2.1 et seq. is the "entire taxable gross income" derived from Indiana sources and not, as taxpayer would prefer, one's "Indiana adjusted gross income." That taxpayer was unable to reap the benefit of its bargain does not justify re-characterization of the amounts received pursuant to the contract. Income received for the provision of medical services cannot be re-characterized as reimbursements for expenditures made in an agency capacity.

FINDING

Taxpayer's protest is denied.

II. Gross Income Tax – Health Maintenance Organizations

DISCUSSION

Taxpayer believes that even if the M HMO "reimbursements" were not received in an agency capacity, taxpayer, as an HMO, still would not have incurred additional Indiana gross income tax liabilities. Taxpayer explains:

> Assuming, but certainly not conceding, that the auditor is correct and the amounts received by [Taxpayer] from M HMO are "receipts" to [Taxpayer], then [Taxpayer], as an HMO, which is treated as a health insurance company for gross income tax purposes, does not have any taxable gross income from its contract with M HMO.

As an HMO licensed under IC 27-23, taxpayer argues that it is entitled to exclude from its taxable gross income a portion of its gross fee premium income. Taxpayer opines:

> [I]n DRG 85-1, the Department concluded that HMOs should be treated in the same manner as traditional health insurance carriers and under the authority of Regulation 45 IAC 1-1-68 found that HMOs shall be permitted, in computing their gross income tax liabilities, to exclude from their gross fees…a corresponding amount computed by multiplying the gross fee premium income

> by the ratio of medical and hospital care payments made by the HMO, to premiums earned by the HMO on an annual basis.
>
> Therefore, if as the auditor contends, the amounts from M HMO were "fees" to [Taxpayer] for prepaid health and medical care provided to the enrollees of the Medicaid program, [Taxpayer] should be permitted to used the gross earnings ratio method set forth in DRG 85-1 in arriving at its gross income tax liability for the Tax Year.

The language of DRG 85-1 (issued January 1985) has no effect with regard to transactions occurring during the 1997 tax period. According to *Tax Policy Directive #9* (issued July 1995), "…all rulings issued by the Department prior to January 1, 1990 [were] declared null and void and of no effect for tax years beginning after December 31, 1995."

Additionally, DRG 85-1 could not apply because the income at issue does not represent "gross fee premium income." The income received by taxpayer pursuant to its contract with M HMO represents fees for health care services performed for M HMO ENROLLEES. DRG 85-1, on the other hand, addresses the characterization (for gross income tax purposes) of premium fee income received by HMOs from its OWN ENROLLEES.

FINDING

Taxpayer's protest is denied.

III. Tax Administration - Penalty

Discussion

The Department may impose, in appropriate situations, a ten percent (10%) negligence penalty. See IC 6-8-10-2.1 and 45 IAC 15-11-2. The Department, though, may waive this penalty if taxpayer can establish that its failure to pay the full amount of tax due "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed…." *Id*. In this instance, taxpayer has made such a showing.

FINDING

Taxpayer's protest is sustained.

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